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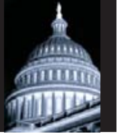

Changes on the Horizon for Banks

By Michael J. Novogradac, CPA

As the economy slowly recovers, and with it the tax credit investment market, it is important to be aware of forthcoming regulatory changes that will affect banks and other financial institutions, that are some of the largest tax credit investors. In their own ways each of these changes have the potential to impact banks' investment decisions in all tax credits, including low-income housing tax credits, new markets tax credits, historic tax credits and renewable energy tax credits.

Basel III and the SIFI Charge

One major change will come out of the implementation of Basel III, a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision (BCBS) to strengthen the regulation, supervision and risk management of the banking sector. Banking regulators say the Basel III rules are intended to raise the level and quality of capital in the system. Among other things, these measures aim to improve the banking sector's ability to absorb shocks that arise from financial and economic stress.

Current Developments

This summer, regulators took meaningful steps in developing the framework required by the Basel III rules for so-called systemically important financial institutions (SIFIs). On June 25, the Group of Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee, agreed on specific measures for global systemically important banks (G-SIBS). The GHOS was expected to submit in late July a final version of its consultative document to the Financial Stability Board (FSB), which is coordinating the overall set of measures. The FSB is due to formally announce its capital recommendations in November.

When the complete Basel III package is implemented by January 1, 2019, SIFI's common equity will be required to be at least 7 percent of risk-weighted assets. This compares to a Basel II level of 2 percent common equity. The 7 percent figure includes a 2.5 percent capital conservation buffer, which sometimes is referred to as the SIFI charge. Other banks' equity will be required to be at least 4.5 percent of risk-weighted assets. The implementation of the SIFI charge will create two tiers of minimal capital requirements that will directly influence the yield needs of the banks in each tier. SIFIs, subject to higher capital reserve requirements, will have to achieve higher average earnings on their investments to generate the same shareholder return.

On June 26, Bloomberg reported at least eight banks may face the 2.5 percent SIFI charge, including the three largest U.S. banks: Bank of America Corporation, JPMorgan Chase & Company and Citigroup Inc. HSBC Holdings Plc and Deutsche Bank AG are also among lenders expected to be subject to the SIFI charge, according Bloomberg, which cited Morgan Stanley analysts.

Bloomberg reported in late June that regulators are also shifting attention to disparities in the way the riskiness of banks' assets are measured. This scrutiny is reported to be

continued on page 2

continued from page 1

in response to concerns that banks may make internal adjustments to risk weighted assets to mitigate the additional loss absorbency requirements. Bloomberg reported that a subcommittee of the Basel Committee may consider a peer-review process and ask a sample of banks to calculate risk weightings on a group of comparable assets to assess whether they are being calculated consistently. These accounts had not been confirmed as the Journal of Tax Credits went to press.

What This Could Mean for Tax Credits

As banks adjust their holdings to meet the new requirements, there are significant implications for their interest in tax credit investments. For example, some residential and commercial real estate lending is considered more volatile and/or a higher risk than other types of lending. The Basel rules weigh the risk for these types of real estate lending more heavily and require banks to hold higher levels of capital against such loans. There is concern that this will have a chilling effect on the flow of credit to the real estate sector, including the tax credit investment sector. As a result, overall market liquidity and valuation could diminish.

CRA Regulation Project

Fortunately, regulatory changes on the horizon could enhance banks' interest in tax credit investments in the form of changes to the Community Reinvestment Act regulations. The CRA is often cited as a primary factor in determining where and how banks provide community development financing. Because the CRA law itself is relatively brief and broad, regulators have fairly wide discretion in implementing it.

> One key concern is that CRA as currently implemented contributes to a geographically imbalanced tax credit market.

Motivated by the CRA, banks have made billions of dollars of successful community development loans and investments. One of the CRA's signature achievements has been to create successful partnerships among banks, all levels of government, and developers and these partnerships help leverage limited public funds. However, concerns have begun to build in recent years about the CRA's effectiveness in encouraging community development.

A key concern is that the CRA as currently implemented contributes to a geographically imbalanced tax credit investment market. Some markets, especially large metropolitan areas where money-center banks face close CRA scrutiny because of their large alloca-

continued on page 3

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continued from page 2

ble deposit bases, appear to be returning to hyper-competition for a limited number of projects. At the same time, in other markets where major banks get much less scrutiny from CRA examiners, investment is scarce and pricing is low. As a result, the tax credit equity market has been split into two tiers, one with high credit prices in high-demand CRA assessment areas and a second with lower or no demand in non-CRA assessment areas. These areas are known as "CRA hot spots" and "CRA dead zones," respectively.

In addition, banks get little recognition for investing through multi-investor funds that operate on a statewide, regional or nationwide basis, which are key vehicles for attracting a wider range of banks to tax credit investing. Moreover, current CRA rules do not fully address the growing segment of banks whose business models do not involve traditional branch networks, including internet banks and investment banks.

Current Developments

Last summer, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision held four public hearings on modernizing the regulations that implement the CRA. The hearings focused on regulatory rather than statutory changes, and addressed the following topics: geographic coverage; performance tests, asset thresholds and designations; affiliate activities; community development; ratings and incentives; and disclosures and performance evaluations. Public comments were accepted through August 31, 2010. A number of suggestions were proposed by the tax credit community to address the concerns about geographic imbalances.

The regulatory agencies were urged to delineate a much smaller number of assessment areas: for example, one for each of the 50 to 100 largest metro areas and the remaining balance of each of the 50 states – a total of 100 to 150 areas nationwide. Another suggestion proposed that banks get equal credit for community development activities delivered directly or through a conduit (e.g., a multi-investor tax credit fund) organized locally, statewide, regionally or nationwide. Proponents of this change argue that the volume and responsiveness of the investment should matter, not the channel through which it is made.

Barry Wides, the Office of the Comptroller of the Currency's deputy comptroller for community affairs, reports that regulators are meeting almost every week, and sometimes more than once a week, for the CRA regulation project. Wides says regulators are still working their way through the public input that was gathered last year; more than 1,600 comment letters were submitted and more than 100 witnesses provided testimony during the four public hearings. No timeline or projected date has been set for the

continued on page 4

continued from page 3

regulation update, but it is likely to take months—if not years—to finalize.

What This Means for Tax Credit Investment

The hearings represented the first wide-ranging review of rules implementing the CRA in several years, potentially changing – for the better – the way banks view affordable housing and other community development activities. At a time when the tax credit investment market could use a boost, changes to CRA implementation would be welcomed by the affordable housing, community development, renewable energy and historic preservation communities. It remains to be seen which proposals regulators will embrace in any proposed changes, but based on the volume of response reported, it's safe to say the opportunity to comment was not wasted on the tax credit community.

Conclusion

The full outcome of the major changes discussed here won't be completely revealed for years but the foundations for a new regulatory landscape are being laid now. And with banks still leading the tax credit investor pack, these changes are of great consequence to the entire tax credit community.

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